REPORT OF EXAMINATION
OF THE

ARGONAUT INSURANCE COMPANY

AS OF
DECEMBER 31, 2005

Participating State
and Zone:

California

Filed June 20, 2007

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San Francisco, California
May 1, 2007

Honorable Alfred W. Gross
Chairman of the NAIC Financial
Condition Committee
Virginia Bureau of Insurance
Richmond, Virginia

Honorable Kent Michie
Secretary, Zone IV-Western
Commissioner of Insurance
Utah Department of Insurance, State of Utah
Salt Lake City, Utah

Honorable Steve Poizner
Insurance Commissioner
California Department of Insurance
Sacramento, California

Dear Chairman and Commissioners:

Pursuant to your instructions, an examination was made of the

ARGONAUT INSURANCE COMPANY

(hereinafter also referred to as the Company) at its home office located at 10101 Reunion Place, Suite 500, San Antonio, Texas 78216. Its statutory home office is located at 250 Middlefield Road, Menlo Park, California 94025.

SCOPE OF EXAMINATION

The previous examination of the Company was made as of December 31, 2002. This examination covers the period from January 1, 2003 through December 31, 2005. The examination was made pursuant to the National Association of Insurance Commissioners' plan of examination. The present examination included a review of the Company’s practices and procedures, an examination of management records, tests and analyses of detailed transactions within the examination period, an evaluation of assets, and a determination of liabilities as of December 31, 2005, as deemed necessary under the circumstances.

Concurrent examinations were conducted of the Company's four subsidiaries that participate in the reinsurance pool: Argonaut Midwest Insurance Company, Select Markets Insurance Company, and Argonaut Limited Risk Insurance Company by the State of Illinois and Argonaut Southwest Insurance Company by the State of Louisiana. Illinois also conducted an examination of Argonaut Great Central Insurance Company, which is not a member of the reinsurance pool.

In addition to those items specifically commented upon in this report, other phases of the Company's operations were reviewed including the following areas that require no further comment: fidelity bonds and other insurance; officers', employees' and agents' welfare and pension plans, loss experience, growth of company; business in force by states; and sales and advertising.

SUBSEQUENT EVENTS

Effective January 1, 2006, the outstanding stocks of Select Markets Insurance Company, formerly Argonaut-Northwest Insurance Company, and Argonaut Limited Risk Insurance Company, formerly Georgia Insurance Company, were contributed to Argonaut Great Central Insurance Company, a wholly-owned subsidiary of the Company.

Effective January 1, 2006, the Company entered into a commutation agreement of the previously approved quota share reinsurance agreements between the Company and its affiliates, Colony Insurance Company, Colony Specialty Insurance Company and Colony National Insurance Company. As a result of this commutation, the Company's surplus increased by $6,748,397.

The Company is a party to a services agreement, which was approved by the California Department of Insurance (CDI) on December 12, 2005. Under this agreement, effective January 1, 2006, the Select Market Management Services (SMMS) division of Argonaut Management Services, Inc. provides its affiliates various administrative services including services related to underwriting, claims, administration and staffing, financial accounting and recordkeeping, reinsurance, system design and maintenance, regulatory inquiries and complaints, and litigation services for designated property and casualty insurance policies. SMMS is paid a reimbursement fee based on estimated actual cost.

Effective September 20, 2006, the Company sold its statutory home office land and building located in the Menlo Park, California for $8,000,000 to King Asset Management Corporation and Roxy Development Company (Buyer). Pursuant to an assignment of purchase agreement effective September 15, 2006, the Buyer transferred its interest as buyer under the purchase agreement to 250 Middlefield Associates LLC and Roxy Rapp. The Company is now occupying the premises as a tenant.

The Company re-domesticated to Illinois, effective December 31, 2006. The re-domestication was approved by the CDI on December 16, 2006.

On March 14, 2007, PXRE, Argonaut Group, Inc. Argonaut) and PXMS Inc., a Delaware corporation and wholly-owned subsidiary of PXRE executed a Merger Agreement and Plan of Merger. Following completion of the transactions contemplated by the merger agreement and appropriate regulatory approvals, PXRE (as renamed) will become the ultimate controlling entity of Argonaut and all of the subsidiaries of Argonaut, and will continue to be the ultimate controlling entity of all of the existing subsidiaries of PXRE.

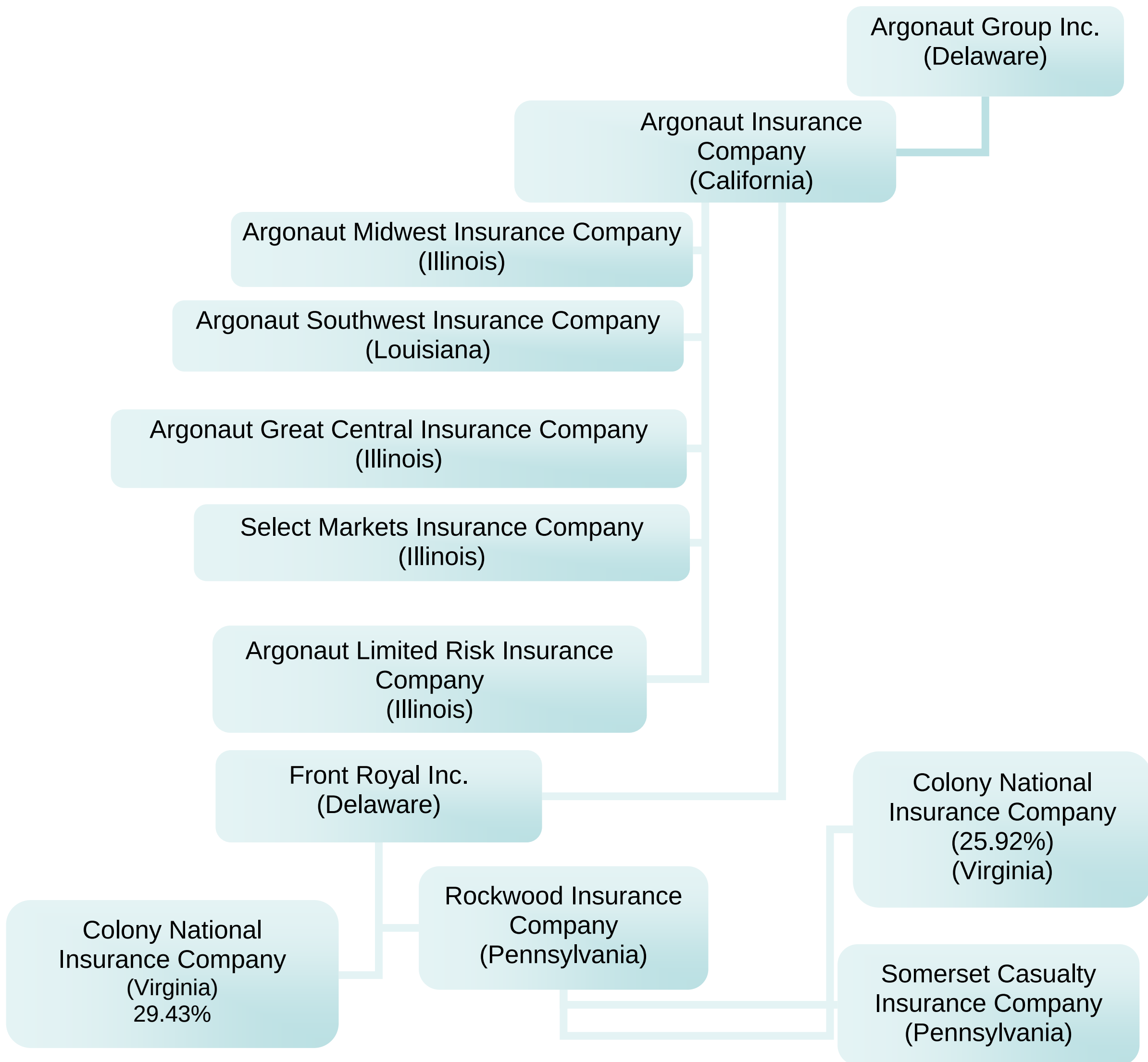
The Company stated that it plans to make changes to its current pooling arrangement that will result in quota share reinsurance agreements between the Company, its pooled subsidiaries and Argonaut Great Central Insurance Company, its wholly-owned subsidiary. The anticipated date for these changes is July 1, 2007 and is contingent upon all applicable regulatory approvals.

COMPANY HISTORY

Effective December 31, 2003, the Company paid a $76,792,538 extraordinary dividend to its parent, Argonaut Group, Inc., consisting of all of the shares of Colony Insurance Company. The California Department of Insurance approved the payment of the dividend, providing that the Company first receive a $71 million surplus contribution in cash. The Company received the $71 million in cash on February 6, 2004 from its parent. The $71 million received in exchange for the shares of Colony Insurance Company was part of a total surplus contribution of $124,439,720 in 2004 by the Company from its parent.

MANAGEMENT AND CONTROL

The Company is a member of an insurance holding company system of which Argonaut Group, Inc. (AGII) owns 100% of the outstanding stock of the Company. The largest single shareholder of AGII is the Singleton Group LLC, which owns or beneficially controls 14% of the outstanding stock of AGII. The Singleton Group LLC has disclaimed affiliation and control of AGII. The following chart depicts the interrelationship of the Company and its subsidiaries, as of December 31, 2005, within the holding company system (all ownership is 100% unless otherwise noted):


Argonaut Group Inc.
(Delaware)
Argonaut Insurance Company
(California)
Argonaut Midwest Insurance Company
(Illinois)
Argonaut Southwest Insurance Company
(Louisiana)
Argonaut Great Central Insurance Company
(Illinois)
Select Markets Insurance Company
(Illinois)
Argonaut Limited Risk Insurance Company
(Illinois)
Front Royal Inc.
(Delaware)
Colony National Insurance Company
(25.92%)
(Virginia)
Rockwood Insurance Company
(Pennsylvania)
Colony National Insurance Company
(Virginia)
29.43%
Somerset Casualty Insurance Company
(Pennsylvania)

The three-member board of directors manages the business and affairs of the Company. The following are the members of the board of directors and principal officers of the Company serving at December 31, 2005:

Directors

Name and Residence	Principal Business Affiliation
Mark William Haushill San Antonio, Texas	Senior Vice President and Chief Financial Officer Argonaut Group, Inc.
Byron Louis LeFlore, Jr. San Antonio, Texas	Senior Vice President and General Counsel Argonaut Group, Inc.
Mark Edmund Watson III * San Antonio, Texas	President and Chief Executive Officer Argonaut Group, Inc.

Principal Officers

Name	Title
Byron Louis LeFlore, Jr.**	President
Mark William Haushill	Senior Vice President and Treasurer
Craig Stephen Comeaux	Vice President and Secretary
John Francis Gribbin	Executive Vice President
Charles Wayne Weaver	Senior Vice President
Samuel Collins Anderson	Vice President
Terri Lee Blauer	Vice President - WC Claim
Marilyn Anne Brands	Vice President – Underwriting
Kevin Patrick Brooks	Vice President
Stephen Kenneth High***	Vice President – Chief Information Officer
Rhonda Kelley Ijams	Vice President
Dennis Bryon Kisler ****	Vice President
Carl Merrill Lambert	Vice President – Safety Management
Mary Margaret Scavarda	Vice President
Daniel Wilson Huckemeyer****	Regional Vice President – Midwest Region
Margaret O'Brien Johnson	Regional Vice President – Eastern Region

* Replaced by Craig Stephen Comeaux effective July 27, 2006. Mark Edmund Watson III continues to serve as President and CEO of Argonaut Group, Inc.

** Replaced as President of the Company by Benjamin Thomas Johns effective July 27, 2006. Byron Louis LeFlore, Jr. has been elected to the position of Senior Vice President effective July 27, 2006.

*** Replaced by John J. McQuade effective July 27, 2006. Steven Kenneth High continues to serve as Vice President and Chief Information Officer of Shared Services for Argonaut Group, Inc.

**** Resigned effective March 31, 2006 and May 1, 2006, respectively. Dennis Bryon Kisler was replaced by Roger Fisher effective July 27, 2006. Daniel Wilson Huckemeyer was not replaced.

Intercompany Agreements

The Company was not in compliance with California Insurance Code (CIC) Section 1215.5 (b)(4) because it did not file a managing general agent agreement, effective July 1, 2000, with Trident Insurance Services, LLC, an affiliate. The Company filed this agreement with the California Department of Insurance (CDI) on March 29, 2007.

The Company is a party to a general services agreement with Argonaut Management Services, Inc. (AMSI) effective December 31, 2002. Under the terms of the agreement, AMSI provides certain general services which include: legal, accounting, tax and other financial services, system design and maintenance, external reporting services, services pertaining to personnel administration, including payroll services, benefits and benefit plans, executive oversight, corporate and business development strategy consulting services, and services pertaining to marketing, corporate communications and public relations. Compensation for these services is on an actual cost basis. The CDI approved this agreement on January 29, 2003.

Argonaut Group, Inc. established an inter-company tax allocation agreement with its subsidiary companies, including the Company effective December 31, 2001. The tax charge or tax refund for each subsidiary company under the agreement is the amount that the subsidiary would have paid or received had they filed on a separate return basis.

The Company is a party to a claim checks disbursement services agreement with Colony Insurance Company (Colony) effective July 1, 2005 that provides for claim checks be written on Colony's bank check stock to pay Company claims. The Company reimburses Colony the full amount within thirty days following the end of the month in which the funds were disbursed. The CDI approved this agreement on December 12, 2005.

The Company is a party to a services agreement with Colony Management Services, Inc (CMSI) effective July 1, 2005. CMSI provides the Company with various administrative services including services related to underwriting, claims, administration, financial accounting and recordkeeping, regulatory inquiries, complaints and litigation and reinsurance services for designated property and casualty insurance policies. As of December 31, 2005, business produced by CMSI was 6% of direct written premiums on a pooled basis. The CDI approved this agreement on December 12, 2005.

TERRITORY AND PLAN OF OPERATION

The Company was licensed in all fifty states, the District of Columbia, Guam, and the U.S. Virgin Islands, with direct writings concentrated in California (25%), New York (13%), and Florida (8%). The Company was authorized to write all lines of business except life, title, mortgage guaranty, and financial guaranty.

The Company announced on August 29, 2005 that it sold the renewal rights to a substantial portion of its risk management business to XL America, Inc. (XL). Under the agreement, XL began offering renewal quotes to workers' compensation policyholders beginning in September, 2005. In addition, policyholders renewing with XL continue to have access to claims management and loss control services through Argonaut Claims Services.

Workers' compensation was the primary line of business underwritten by the Company prior to the sale of its renewal rights, representing 61% of its direct premium writings in 2005. The Company stated that this percentage will decrease substantially going forward, given the XL transaction and that the Company is now being utilized within the Argonaut Group for other property and casualty lines. At December 31, 2005, approximately 29% of the direct premiums written on a pooled basis were written on the Company's policy form and ceded to Argonaut Great Central Insurance Company.

As of 2005, business primarily was written through national brokerage firms and large regional brokers. The active agency force consists of 139 brokers and general agents, and 3 managing general agents.

In 2001, the Company moved its home office operations from Menlo Park, California to the current location in San Antonio, Texas. Certain limited functions remain in Menlo Park, most notably some actuarial, reinsurance and underwriting personnel.

REINSURANCE

The Company, along with four of its subsidiaries participated in a reinsurance pooling agreement whereby premiums, losses, and underwriting expenses are pooled in the following percentages:

Argonaut Insurance Company	92.0%
Argonaut Midwest Insurance Company	6.6%
Argonaut Southwest Insurance Company	0.7%
Argonaut Northwest Insurance Company	0.6%
Georgia Insurance Company	0.1%
Total	100.0%

This agreement has been in existence since 1977, and was last amended in 1984. Terms of the agreement call for all premiums and losses of the subsidiaries in the pool to be ceded to the Company, and then retroceded to the subsidiaries in the respective percentages. The agreement calls for the Company to pay for all losses and underwriting expenses, collect all premiums, and secure reinsurance for the pool. Federal income taxes and investment expenses are specifically excluded from the pooling agreement. The agreement also calls for settlement of inter-company balances between pool members on at least a quarterly basis.

Assumed

In addition to premiums assumed under the reinsurance pooling agreement, the Company entered into various reinsurance agreements with affiliates and non-affiliates that are summarized below:

Affiliates:

Effective January 1, 2004, the Company assumes 90% of Argonaut Great Central Insurance Company's business referred to as Public Entity underwritten by Trident Insurance Services, an affiliated Managing General Underwriter. Assumed premiums received in 2005 under this quota share reinsurance agreement totaled $46.7 million. This agreement was approved by the California Department of Insurance (CDI) on August 10, 2004.

Effective July 1, 2004, the Company assumes 12.5% of "Colony Insurance Group of Companies" business. Assumed premiums received in 2005 under the quota share reinsurance agreement totaled $45.6 million. The agreement was approved by the CDI on October 15, 2004 and was commuted January 1, 2006.

Non-affiliates:

Effective April 1, 2005, the Company assumes commercial auto and other liability business under a quota share reinsurance agreement with Fireman's Fund Insurance Company, on behalf of the Fireman's Fund Group insurers Interstate Indemnity Company, Interstate Fire & Casualty Company, and Fireman's Fund County Mutual Insurance Company (collectively the three companies are referred to as Fireman's Fund Companies). This agreement was entered into pursuant to a Renewal Rights Agreement where business previously written by the Fireman's Fund Companies would be assumed by the Company and, upon renewal, would be written by the Company as direct business or one of the three Colony companies on a direct basis. This quota share reinsurance was placed in the intercompany pool. As a result of this agreement, written premium increased by $91.3 million in 2005.

Effective January 1, 2003, the Company assumes business under a quota share reinsurance agreement with Houston Casualty Company and its affiliates. This agreement covers all business (domestic and international) underwritten by HCC Global Financial Products LLC for the reinsured companies and classified as directors and officers liability and other coverages. The Company renewed the agreement effective January 1, 2005 with 1.5% participation. Assumed premiums received in 2005 under this agreement totaled $6.4 million.

In addition, the Company participates in a small number of voluntary and involuntary pools.

Ceded

The following is a summary of the main reinsurance agreements in effect at December 31, 2005:

Line of Business and Type of Contract	Reinsurer's Name	Company's Retention	Reinsurer's Limit
Workers' Compensation, Employers' Liability including US Long shore & Harbor WC Act, Auto Liability, General Liability, and other casualty business:			
First Comprehensive Casualty Excess of Loss	American Re-Insurance Company (100%)	$2 million each and every loss occurrence	$3 million in excess of $2 million each and every loss occurrence with a $12 million annual aggregate limit

Line of Business and Type of Contract	Reinsurer's Name	Company's Retention	Reinsurer's Limit
Second Casualty Clash Excess of Loss	American Re-Insurance Company (10%); Aspen Insurance UK Limited (24.64%); Lloyd's Syndicates (45.36%); and Odyssey American Reinsurance Corporation (20%)	$5 million each and every loss occurrence	$5 million in excess of $5 million each and every loss occurrence with a $15 million annual aggregate limit
Third Casualty Clash Excess of Loss	Aspen Insurance UK Limited (23.93%), Lloyd's Syndicates (76.07%)	$10 million each and every loss occurrence	$10 million in excess of $10 million each and every loss occurrence with a $20 million annual aggregate limit
First Catastrophe Excess of Loss	Ace Property & Casualty (5%), Aspen Insurance UK Limited (5%), Allied World Assurance Company (7.5%), Axis Specialty Ltd (2.5%), Endurance Specialty Insurance Ltd (17.5%), Hannover Ruckversicherungs AG (12.5%), Lloyd's Syndicate (5%), Partner Reinsurance Co of the U.S. (10%), Platinum Underwriters Reinsurance, Inc (5%) and Swiss Reinsurance America (30%)	$20 million each and every loss occurrence	$30 million each and every loss occurrence in excess of $20 million with a $60 million annual aggregate limit
Second Catastrophe Excess of Loss	Aspen Insurance UK Limited (8%), Allied World Assurance Company (10%), Axis Specialty Ltd (13.5%), Endurance Specialty Insurance Ltd (21.5%), Hannover Ruckversicherungs AG (16%), Lloyd's Syndicates (14.5%), Platinum Underwriters Reinsurance Inc (10%) Swiss Reinsurance America (6.5%)	$50 million each and every loss occurrence	$50 million each and every loss occurrence in excess of $50 million with a $100 million annual aggregate limit

Line of Business and Type of Contract	Reinsurer's Name	Company's Retention	Reinsurer's Limit
Third Catastrophe Excess of Loss	Aspen Insurance UK Limited (7.5%), Allied World Assurance Company (7.5%), Axis Specialty Ltd (25%), Endurance Specialty Insurance Ltd (20%), Hannover Ruckversicherungs AG (15%), Lloyd's Syndicate (20%), and Platinum Underwriters Reinsurance Inc (5%)	$100 million each and every loss occurrence	$12.5 million each and every loss occurrence in excess of $100 million with a $25 million annual aggregate limit

Effective July 1, 2000, the Company entered into a reinsurance agreement with Argonaut Great Central Insurance Company (AGCIC), an affiliate, where direct written business of the Company that is produced by Trident Insurance Services, LLC and identified as "Public Entity Core Program Insurance" is 100% ceded to AGCIC.

The Company entered into multiyear contractual agreements with seven states under the "State Fund Program," which was developed to allow a state to write workers' compensation policies for domiciled companies with out-of-state operations. For a fee, the Company fronts the out-of-state business for the state. The policies are issued on the Company's policy form. The state then assumes 100% of the liability. Letters of credit or loss deposits are provided to cover paid and unpaid losses and unearned premiums.

The Company is a participant in the "Colony" casualty excess of loss and "Transportation" excess of loss reinsurance contracts, which covers casualty business including reinsurance assumed from the Fireman's Fund Group as part of the renewal rights acquisitions.

In addition, the Company has 186 facultative reinsurance agreements in force at year-end with 2005 premiums ceded totaling $9,053,100.

The offset clause of the main reinsurance treaties, “Colony” casualty excess of loss reinsurance contract, “Transportation” excess of loss reinsurance contract, and “State Fund Program” reinsurance contracts with seven states mentions the word insolvency and/or includes non-specific language such as “any other amount” or “any other contract.” It is recommended that the Company amend these reinsurance contracts to omit the reference to insolvency.

The Company commuted the reinsurance agreements with Trenwick America Reinsurance Company effective December 20, 2005 and Inter-Ocean N.A. Reinsurance Company, Ltd. effective September 15, 2005. As a result of these commutations, the Company recorded a total reduction of $51.6 million in policyholders’ surplus.

ACCOUNTS AND RECORDS

The Company could not readily supply detail for certain transactions, and in some cases, when detail was provided, it was not sufficient. During testing of premiums, it was noted that the Company could not provide full support documentation for eight of its policies. It is recommended the Company maintain adequate documentation to support its premium transactions. The Company has stated this is not a problem going forward.

During testing of collateral funds held, it was noted that the Company was not able to provide documentation of agreements with the insured or the custodial bank. The asset was admitted as there is an offsetting liability. It is recommended the Company maintain adequate documentation to support its collateral loans.

During testing of losses and loss adjustment expenses, it was noted that the Company could not provide cancelled checks for five of its payments and also was unable to locate two of its claim files. This did not affect the review of the Company’s reserves as the payments were traced to supporting documentation. It is recommended the Company maintain adequate support for its loss and loss adjustment expenses and implement procedures to better track its claim files.

Unclaimed Property:

The Company is not in compliance with its own procedures regarding unclaimed property. During testing, it was noted that serious attempts to contact payees were not documented. In addition, it was noted that checks issued to payees such as Commonwealth of Pennsylvania and Commonwealth of Massachusetts were submitted to the State of California. It is recommended the Company comply with its own procedures and contact the appropriate state when reporting unclaimed funds.

Information Systems:

During the course of the examination, a review was made of the Company's general controls over its information systems. As a result of the review, weaknesses were noted in program change controls. It is recommended the Company take steps to improve its program change controls and to continue to test its Disaster Recovery Plan on yearly basis. It is also recommended the Company conduct its Disaster Recovery testing at an alternate back up site.

FINANCIAL STATEMENTS

The financial statements prepared for this examination report include:

Statement of Financial Condition as of December 31, 2005

Underwriting and Investment Exhibit for the year Ended December 31, 2005

Reconciliation of Surplus as Regards Policyholders
from December 31, 2002 through December 31, 2005

Reconciliation of Examination Changes as of December 31, 2005

Statement of Financial Condition
as of December 31, 2005

Assets	Ledger and Nonledger Assets	Assets Not Admitted	Net Admitted Assets	Notes
Bonds	$ 466,244,768	$	$ 466,244,768	
Common stocks	489,808,383	10,120,376	479,688,007	(1)
Real estate: Properties occupied by company	71,158		71,158	
Cash and short term investments	89,206,550		89,206,550	
Other invested assets	17,902,887		17,902,887	
Aggregate write-ins for invested assets	20,305,158		20,305,158	
Investment income due and accrued	5,860,681		5,860,681	
Premiums and agents' balances in course of collection	49,549,674	15,989,421	33,560,253	(2)
Premiums, agents' balances and installments booked but deferred and not yet due	13,170,313		13,170,313	
Accrued retrospective premiums	6,973,600	697,360	6,276,240	
Amounts recoverable from reinsurers	58,933,632		58,933,632	(3)
Funds held by or deposited with reinsured companies	52,820,165	2,878,000	49,942,165	(2)
Current federal and foreign income tax recoverable and interest thereon	449,000		449,000	
Net deferred tax asset	124,182,000	106,841,000	17,341,000	
Guarantee funds receivable or on deposit	1,613,335		1,613,335	
Receivables from parent, subsidiaries and affiliates	221,182		221,182	
Aggregate write-ins for other than invested assets	12,421,651	5,495,024	6,926,627	
Total assets	$1,409,734,137	$142,021,181	$1,267,712,956	

Liabilities, Surplus and Other Funds			
Losses and loss adjustment expenses		$ 664,963,435	(4)
Reinsurance payable on paid losses and loss adjustment expenses		3,708,642	(6)
Commissions payable, contingent commissions and other similar charges		3,533,754	
Other expenses		8,199,272	
Taxes, licenses and fees		8,187,114	(5)
Unearned premiums		105,153,070	
Dividends declared and unpaid: Policyholders		182,396	
Ceded reinsurance premiums payable		12,297,031	
Funds held by company under reinsurance treaties		1,271,296	
Amounts withheld or retained by company for accounts of others		49,367,551	(7)
Remittances and items not allocated		8,173,739	(2)
Provision for reinsurance		26,178,343	
Payable to parent, subsidiaries and affiliates		2,868,270	
Aggregate write-ins for liabilities		37,862,053	
Total liabilities		931,945,966	
Common capital stock	$ 4,500,000		
Gross paid-in and contributed surplus	183,407,125		
Unassigned funds (surplus)	147,859,865		
Surplus as regards policyholders		335,766,990	
Total liabilities, surplus and other funds		$1,267,712,956	

Underwriting and Investment Exhibit
for the Year Ended December 31, 2005

Underwriting Income

Premiums earned		$196,567,522
Deductions:		
Losses and loss expenses incurred	$118,941,524	
Other underwriting expenses incurred	85,718,787	
Total underwriting deductions		204,660,311
Net underwriting loss		(8,092,789)

Investment Income

Net investment income earned	$ 26,202,845	
Net realized capital gains	3,038,220	
Net investment gain		29,241,065

Other Income

Net loss from agents' or premium balances charged off	$ (7,794,788)	
Aggregate write-ins for miscellaneous income	(38,985,002)	
Total other income		(46,779,790)
Net loss before dividends to policyholder and federal and foreign income taxes		(25,631,514)
Dividends to policyholders		661,303
Federal and foreign income taxes incurred		(211,000)
Net loss		$ (26,081,817)

Capital and Surplus Account

Surplus as regards policyholders, December 31, 2004		$372,403,614
Net loss	$ (26,081,817)	
Change in net unrealized capital gains	14,859,702	
Change in net unrealized foreign exchange capital loss	(195,677)	
Change in net deferred income tax	13,416,000	
Change in nonadmitted assets	(16,383,329)	
Change in provision for reinsurance	1,167,913	
Aggregate write-ins for gains and losses in surplus	(23,419,416)	
Change in surplus as regards policyholders for the year		(36,636,624)
Surplus as regards policyholders, December 31, 2005		$335,766,990

Reconciliation of Surplus as Regards Policyholders
from December 31, 2002 through December 31, 2005

	Gain in Surplus	Loss in Surplus	
Surplus as regards policyholders, December 31, 2002, per Examination			$215,030,394
Net income	$ 44,231,223	$	
Change in net unrealized capital gains	22,657,813		
Change in net unrealized foreign exchange capital losses		62,425	
Change in net deferred income tax	48,634,000		
Change in non admitted assets		9,516,230	
Change in provision for reinsurance		3,494,951	
Surplus adjustments: Paid in	124,439,720		
Dividends to stockholders		76,792,538	
Aggregate write-ins for losses in surplus		29,360,016	
Total gains and losses	$239,962,756	$119,226,160	
Increase in surplus as regards policyholders			120,736,596
Surplus as regards policyholders, December 31, 2005, per Examination			$335,766,990

Reconciliation of Examination Changes as of December 31, 2005

	Per Company	Per Examination	Increase (Decrease) in Surplus	Notes
Assets				
Common stocks	$483,963,588	$479,688,007	$ (4,275,581)	(1)
Uncollected premiums and agents' balances in course of collection	87,029,828	33,560,253	(53,469,575)	(2)
Funds held by or deposited with reinsured companies	0	49,942,165	49,942,165	(2)
Liabilities				
Reinsurance payable on paid losses and loss adjustment expenses	4,036,837	3,708,642	328,195	(6)
Remittances and items not allocated	0	8,173,739	(8,173,739)	(2)
Decrease in surplus, per examination			(15,648,535)	
Surplus as regards policyholders, December 31, 2005, per Company			351,415,525	
Surplus as regards policyholders, December 31, 2005, per Examination			$335,766,990	

COMMENTS ON FINANCIAL STATEMENT ITEMS

(1) Common Stocks

The examination adjustment of $767,230 is based on the reevaluation of the four subsidiaries participating in the pooling agreement. The Argonaut Great Central Insurance Company examination conducted concurrently by Illinois resulted in examination adjustments of $3,508,351.

(2) Uncollected Premiums and Agents' Balances In Course Of Collections
Funds Held By or Deposited With Reinsured Companies
Remittances and Items Not Allocated

Included in this asset account was $52,820,165 representing funds held by Colony Insurance Company, Colony Specialty Insurance Company and Colony National Insurance Company, affiliates, pursuant to the terms of reinsurance agreements. These funds should have been reported and accounted for in the Annual Statement as “Funds held by or deposited with reinsured companies” in accordance with Statement of Statutory Accounting Principles (SSAP) No.62, Paragraphs 35 and 20. It was noted that the funds held exceeded the liabilities they secured by $2,878,000 on a pooled basis. The excess amount should have been disallowed as admissible assets pursuant to SSAP No. 62, Paragraph 20. For the purpose of this examination report, the $52,820,165 was reclassified to “Funds held by or deposited with reinsured companies” pursuant to SSAP No. 62, Paragraph 35 and the $2,878,000 was disallowed as admissible assets pursuant to SSAP No. 62, Paragraph 20. These funds held were settled on March 2, 2006 because the reinsurance agreements were commuted effective January 1, 2006.

It was noted that the assumed premium receivable per the General Ledger differs from the amount reported in Schedule F, Part 1,Column 10. The Company stated that "In essence the Schedule F was used taking the direct written premiums per Schedule T at December 31, 2005 and subtracting the September 30, 2005 Schedule T direct premiums to report the amounts in column 10 of Schedule F. It also stated that…“for 2006 the proper premiums receivable will be reported for Schedule F.”

The Company uses its agents' credit balances to offset unrelated nonadmitted balances that are over 90 days old which is in not in compliance with the annual statement instructions and the NAIC Accounting Practices and Procedures Manual, SSAP Number 64, Paragraph 4. The Company has taken $8,884,499 in credit balances in the aggregate to offset the debit balances on a pooled basis. The Company's 92% share of this amount is $8,173,739 which has been reclassified to remittances and items not allocated.

In addition, the Company has debit balances over 90 days old that should be nonadmitted pursuant to SSAP Number 6, Paragraph 9c in the amount of $22,327,104 less collateral ($4,949,614) and previously nonadmitted ($7,756,054) for a net adjustment of $9,590,379 on a pooled basis. The Company's 92% share of this adjustment is $8,823,149.

(3) Amounts Recoverable from Reinsurers

It was noted that the Company's system ages the "state funds program" paid loss and loss adjustment expense recoverable or bordereau billings by adding 7 days grace period from the bill date to allow for mail time and 30 days for the reinsurer to pay. Whenever the calculated due date falls in the middle of the month, the system uses the month-end date as the due date. This practice was not in compliance with the annual statement instructions, which require that a paid loss and loss adjustment expense recoverable is due pursuant to original contract terms. It is recommended that the Company comply with the annual statement instructions.

(4) Losses and Loss Adjustment Expenses

A Casualty Actuary from the California Department of Insurance reviewed the loss and loss adjustment expense reserves as of December 31, 2005 and concluded that the reserves were reasonable.

(5) Taxes, Licenses and Fees

California Insurance Code (CIC) Section 1872.8(a) states, in part, that each insurer doing business in the State of California must pay an annual Vehicle Fraud Assessment Fee for each vehicle insured under an insurance policy it issues in California. The fee provides funding for the increased investigation and prosecution of fraudulent automobile insurance claims and automobile theft in the State of California.

During the course of this examination, it was noted that the Company was not in compliance with CIC section 1872.8(a) as it did not pay an assessment on all vehicles as defined in the California Code of Regulations Section 2698.61(r). It is recommended the Company review its filings and submit revised reports to the California Department of Insurance. It is also recommended the Company comply with CIC Section 1872.8(a).

(6) Reinsurance Payable on Paid Losses and Loss Adjustment Expenses

Based on subsequent settlements of accounts, this liability account was decreased by $328,195 to $3,708,642.

(7) Amounts Withheld or Retained by the Company for the Account of Others

A sample was selected from the items which comprised the account, but the Company was unable to provide adequate support documentation to verify either the accuracy or completeness of this account. It is recommended the Company develop documentation to document receipt and disbursements of collateral held in this account.

SUMMARY OF COMMENTS AND RECOMMENDATIONS

Current Report of Examination

Accounts and Records – (Page 14): It is recommended the Company maintain adequate documentation to support its premium transactions, collateral funds held, and loss and loss adjustment expense transactions. It is also recommended the Company implement procedures to better track its claims files.

Accounts and Records – (Page 14): It is recommended the Company comply with its own procedures and contact the appropriate state when reporting unclaimed funds.

Accounts and Records – (Page 14): It is recommended the Company strengthen its program change controls and continue to test its Disaster Recovery Plan on an annual basis. It is also recommended the Company perform these tests at an alternate site.

Uncollected Premiums and Agents' Balances In Course Of Collection, Funds Held By Or Deposited With Reinsured Companies and Remittances and Items Not Allocated – (Page 20): It is recommended that the Company comply with SSAP No. 62, Paragraphs 20 and 35 and SSAP No. 6, Paragraph 9.

Amounts Recoverable from Reinsurers – (Page 21): It is recommended that the Company comply with the annual statement instructions in aging its paid loss and loss adjustment expense recoverable from the "state funds".

Taxes, Licenses and Fees – (Page 22): It is recommended the Company comply with CIC Section 1872.8(a). by counting its vehicles in accordance with CCR Section 2698.61(r).

Amounts Withheld or Retained by the Company for the Account of Others – (Page 22): It is recommended the Company develop documentation to document receipt and disbursements of collateral held in this account.

Previous Report of Examination

Accounts and Records – (Page 14): It was recommended that the Company analyze its general ledger accounts on a regular basis and be able to provide reconciliations between subsidiary reports and general ledger accounts. The Company has complied.

ACKNOWLEDGMENT

Acknowledgment is made of the cooperation and assistance extended by the Company's officers and employees during the examination.

Respectfully submitted,

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